

ASSOCHAM

FINANCIAL

PULSE

STUDY

***“Indian Banking Sector: Capital Adequacy
under Basel II”***

June 2009

Prepared by

Gaurav Sharma

Assocham Research Bureau

INTRODUCTION:

During one of the toughest years faced by the banks and financial institutions globally, the banking sector world over was crippled by massive capital depletion caused by losses and write-downs while their balance sheets clogged by complex credit products and other illiquid assets of uncertain value.

Failure of number of banks in countries like US, UK, Iceland, Ukraine, Belgium, Ireland, Latvia, Russia and Spain had severe impact on their economy. However, the Indian banking sector not only resisted such a scenario but improved significantly. US alone accounted for as many as 60 banks failures during 2008-09, costing the FDIC Deposit Insurance Fund nearly a whopping USD 25 billion.

In stark contrast to the deterioration in the capital base of the banking sector in major parts of the world, Indian banks' compliance to sound banking practices envisaged by the Basel II norms laid strong foundation of a robust banking and financial system.

The process of implementing Basel II norms in India has been carried out in phases. Phase I has been carried out for foreign banks operating in India and Indian banks having operational presence outside India with effect from March 31, 2008.

In phase II, all other scheduled commercial banks (except Local Area Banks and RRBs) have been made to adhere to Basel II guidelines from March 31, 2009. Considering the full implementation of Basel II norms, banks are looking to maintain a cushion in their respective capital reserves.

The minimum capital to risk-weighted asset ratio (CRAR) in India is placed at 9 per cent, one percentage point above the Basel II requirement. All the banks have their Capital to Risk Weighted Assets Ratio (CRAR) above the stipulated requirement of Basel guidelines (8 per cent) and RBI guidelines (9 per cent). As per Basel II norms, Indian banks should maintain tier I capital of at least 6 per cent.

An analysis of the ten banks that announced their capital adequacy ratios as per both Basel I and Basel II found that Indian banking sector has proved to be based on prudent lending practices and sound fundamentals.

The average CAR of the analyzed banks as per Basel II norms improved from 12.35 per cent for the year ended March 2008 to 13.48 per cent in FY '09.

TIME PERIOD:

The report prepared by the ASSOCHAM Research Bureau has taken corporate results announced by for the financial year ending March 2009. Those banks have been taken that have announced their financial results from May 1st - May 31st 2009.

DATA SOURCE:

The report is prepared is based on the data posted by banks on the Bombay Stock Exchange website. i.e. their Financial Results for FY 2008-09.

SAMPLE SIZE:

The ASSOCHAM Research Bureau (ARB) has taken all the 10 banks that announced their capital adequacy ratio as per both Basel I and Basel II for FY 2009-10.

PARAMETERS:

The AEP analysis of the Indian banking sector is based on parameters relating to the capital adequacy ratio of banks as per Basel I and Basel II.

METHODOLOGY:

Simple average and the year on year change in Capital Adequacy Ratio (CAR) during FY 2008-09 as per both Basel I and Basel II have been analyzed for a comparative Study.

EXECUTIVE SUMMARY

- The average CAR of the analyzed banks as per Basel II norms improved from 12.35 per cent for the year ended March 2008 to 13.48 per cent in FY '09.
- From 12.33 per cent in FY '08 to 12.35 per cent in FY '09, the average CAR of banks as per the Basel I formula stood firm demonstrating the soundness of resilient Indian banking sector.
- An improvement in the average CAR of 1.13 per cent during one of the toughest years faced by the banking sector globally marks the superiority of sound Indian banks.
- Despite stringent and even rigorous capital adequacy norms, the remarkable performance of Indian banks during the crisis period has defied the withering collapse in the financial sector.
- Failure of the banking system in number of countries like US, UK, Iceland, Ukraine, Belgium, Ireland, Latvia, Russia and Spain had severe impact on their economy. However, the Indian banking sector not only resisted such a scenario but improved significantly.
- US alone accounted for as many as 60 banks failures during 2008-09, costing the FDIC Deposit Insurance Fund a whopping USD 25 billion.
- To avoid any complacency in the banking sector regulations, the government injected capital into the public sector banks that had their capital adequacy ratio (CAR) below 12 per cent.

In defiance of global financial sector breakdown, capital adequacy of Indian banking sector improved significantly in FY '09: ASSOCHAM

Dwarfing the global meltdown in financial sector and big bank failures in developed countries, Indian banking sector stands impregnable as the capital adequacy of banks show signs of improvement even with implications of more rigorous Basel II norms in FY '09, according to an Assocham Financial Pulse (AFP) Study.

The AFP Study titled “Indian Banking Sector: Basel II” stated that, based upon prudent lending practices and strong fundamentals, the Indian banking sector weathered the storm rising out of the global financial crises aptly during FY 2008-09. The capital adequacy ratio (CAR) of the ten banks that announced their financial results for year ended March 2009 as per both Basel I and Basel II norms shown significant improvement during testing times.

The average CAR of the analyzed banks as per Basel II norms improved from 12.35 per cent for the year ended March 2008 to 13.48 per cent in FY '09.

“An improvement in the average CAR of 1.13 per cent (more than one per cent) during one of the toughest years faced by the banking sector globally marks the superiority of sound Indian banks” said Shri D. S. Rawat, Secretary General, ASSOCHAM.

From 12.33 per cent in FY '08 to 12.35 per cent in FY '09, the average CAR of banks as per the Basel I formula stood firm demonstrating the soundness of resilient Indian banking sector.

In addition to the credit risk of the banking sector (as defined by the Basel I accord), the Basel II accord covers a wider spectrum of risks such as operating and market risk. Despite stringent and even rigorous capital adequacy norms, the remarkable performance of Indian banks during the crisis period has defied the withering collapse in the financial sector.

The minimum capital to risk-weighted asset ratio (CRAR) in India is placed at 9 per cent, one percentage point above the Basel II requirement.

INDIAN BANKING SECTOR: CAPITAL ADEQUACY RATIO

S.No.	Name of the Bank	BASEL-I			BASEL-II		
		Year Ended Mar 09	Year Ended Mar 08	Change	Year Ended Mar 09	Year Ended Mar 08	Change
1	State Bank of Bikaner and Jaipur	13.18	13.50	-0.32	14.52	12.51	2.01
2	State Bank of Mysore	12.41	12.34	0.07	13.38	11.73	1.65
3	Indian Overseas Bank	12.70	11.93	0.77	13.20	11.59	1.61
4	Bank of Baroda	12.88	12.91	-0.03	14.05	12.94	1.11
5	Indian Bank	13.27	12.74	0.53	13.98	12.90	1.08
6	Bank of India	13.21	12.95	0.26	13.01	12.04	0.97
7	Uco Bank	9.75	10.09	-0.34	11.93	11.02	0.91
8	Syndicate Bank	11.37	11.22	0.15	12.68	11.82	0.86
9	Punjab National Bank	12.59	12.96	-0.37	14.03	13.46	0.57
10	State Bank of Travancore	12.13	12.68	-0.55	14.03	13.53	0.50
Average		12.35	12.33	0.02	13.48	12.35	1.13

Source: Assocham Financial Pulse

TURBULENCE IN THE GLOBAL BANKING LANDSCAPE:

After the collapse of Lehman brothers in September 2008, crumbling banking institutions in US, UK and other European countries during 2008-09 sought government support by way of massive capital injections to avert severe implications of toxic financial assets worth USD 4 trillion.

US alone accounted for as many as 60 banks failures during 2008-09, costing the FDIC Deposit Insurance Fund a whopping USD 25 billion.

Failure of number of banks in countries like US, UK, Iceland, Ukraine, Belgium, Ireland, Latvia, Russia and Spain had severe impact on their economy. However, the Indian banking sector not only resisted such a scenario but improved significantly.

After pumping in hundreds of billions of dollars to stabilize the domestic banking and financial institutions, the outcome of the stress test of US banking sector highlighted the shortfall of another 75 billion in banks to have adequate capital level.

POLICY RESPONSE TO CAPITAL ADEQUACY IN INDIAN BANKS:

To avoid any complacency in the banking sector regulations, Indian authorities seek USD 3 billion from the World Bank to infuse funds into public sector banks to shore up their capital against various risks to ensure credit flow to productive sectors to beat the economic slowdown.

The government injected capital into the public sector banks that had their capital adequacy ratio (CAR) below 12 per cent. Four PSU banks including Union Bank of India, Uco bank, Central Bank of India and Vijaya Bank received fresh doses of capital from the government.

ANNEXURE:**I. Capital Adequacy Ratio**

Capital adequacy ratio is the ratio which determines the capacity of the bank in terms of meeting the time liabilities and other risk such as credit risk, operational risk.

Capital adequacy ratios ("CAR") are a measure of the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures.

Capital adequacy ratio is defined as: $CAR = \text{Capital} / \text{Risk}$

Capital Adequacy Ratio under Basel I:

Capital Adequacy Ratio = $\text{Tier I Capital} + \text{Tier II Capital} / \text{Risk Weighted Assets}$

Capital Adequacy Ratio in New Accord of Basel II:

Capital Adequacy Ratio = $\text{Total Capital (Tier I Capital} + \text{Tier II Capital)} / \text{Market Risk} + \text{Credit Risk} + \text{Operation Risk}$

Minimum Requirement of Capital Adequacy Ratio (CAR) for banks in India:

Under Basel II norms, 8 per cent is the prescribed Capital Adequacy Norm.

- In case of Scheduled Commercial Banks CAR= 9 per cent
- For New Private Sector Banks CAR = 10 per cent
- For Banks undertaking Insurance Business CAR = 10 per cent
- For Local Area Banks CAR =15 per cent

II. BANKING SECTOR FAILURES IN U.S.

FDIC Insured Failed Banks in US	
2008	2009
Sanderson State Bank	Citizens National Bank
Haven Trust Bank	Strategic Capital Bank
First Georgia Community Bank	Bank United FSB
The Community Bank	Westsound Bank
PFF Bank & Trust	America West Bank
Downey Savings & Loan	Citizens Community Bank
Security Pacific Bank	Silverton Bank
Franklin Bank	First Bank of Idaho
Freedom Bank	First Bank of Beverly Hills
Alpha Bank & Trust	Michigan Heritage Bank
Meridian Bank	American Southern Bank
Main Street Bank	Great Basin Bank
Washington Mutual Bank	American Sterling Bank
Ameribank	New Frontier Bank
Silver State Bank	Cape Fear Bank
Integrity Bank	Omni National Bank
The Columbian Bank and Trust	TeamBank
First Priority Bank	Colorado National Bank
First Heritage Bank, NA	FirstCity Bank
First National Bank of Nevada	Freedom Bank of Georgia
IndyMac Bank	Security Savings Bank
First Integrity Bank, NA	Heritage Community Bank
ANB Financial, NA	Silver Falls Bank
Hume Bank	Pinnacle Bank of Oregon
Douglass National Bank	Corn Belt Bank & Trust
	Riverside Bank of the Gulf Coast
	Sherman County Bank
	County Bank
	Alliance Bank
	FirstBank Financial Services
	Suburban Federal Savings Bank
	Ocala National Bank
	MagnetBank
	1st Centennial Bank
	Bank of Clark County
	National Bank of Commerce

III. US STRESS TEST RESULTS:

According to the US regulators 10 of the top 19 banks further need to raise a total of USD 74.6 billion in capital over the next six months.

Top Banks needing capital

Bank of America	\$33.9 billion
Wells Fargo	\$13.7 billion
GMAC	\$11.5 billion
Citigroup	\$5.5 billion
Morgan Stanley	\$1.8 billion

IV. GLOBAL FINANCIAL CRISIS: A timeline of important events

Events of 2008

JANUARY

- * January, 2008: Stock Market Volatility

FEBRUARY

- * February, 2008: Nationalisation of Northern Rock

MARCH

- * March, 2008: Collapse of Bear Stearns

JUNE

- * June 27, 2008: Bear Market of 2008 declared

JULY

- * July 1, 2008: Bank of America buys Countrywide Financial
- * July, 2008: Oil prices peak at \$147 per barrel as money flees housing and stock assets toward commodities

SEPTEMBER

- * September, 2008: Emergency Economic Stabilization Act of 2008
- * September, 2008: Troubled Assets Relief Program
- * September, 2008: Bankruptcy of Lehman Brothers
- * September, 2008: Federal takeover of Fannie Mae and Freddie Mac
- * September, 2008: American International Group Federal Reserve bailout
- * September, 2008: Merrill Lynch sold to Bank of America Corporation
- * September, 2008: Morgan Stanley and Goldman Sachs confirmed that they would become traditional bank holding companies
- * September, 2008: partial nationalization of Fortis holding

OCTOBER

- * October, 2008: Large losses in financial markets world wide throughout September and October
- * October, 2008: Passage of EESA of 2008
- * October, 2008: Iceland's major banks nationalized

NOVEMBER

- * November, 2008: China creates a stimulus plan
- * November, 2008: Dow Jones Industrial Average (DJIA) touches recent low point of 7,507 points

DECEMBER

- * December, 2008: The Australian Government injects 'economic stimulus package to avoid the country going into recession, December, 2008
- * December, 2008: Madoff Ponzi scheme scandal erupts
- * December, 2008: Belgium government resigns as a result of Fortis nationalization

Events of 2009

JANUARY

- * January 2009: Blue Monday Crash 2009
- * January 2009: U.S. President Barack Obama proposes federal spending bill approaching \$1 trillion in value in an attempt to remedy financial crisis
- * January 2009: Lawmakers propose massive bailout of failing U.S. banks
- * January 2009: the U.S. House of Representatives passes the aforementioned spending bill.
- * January 2009: Government of Iceland collapses.

FEBRUARY

- * February 2009: Canada's Parliament passes an early budget with a \$40 billion stimulus package.
- * February 2009: JPMorgan Chase and Citigroup formally announce a temporary moratorium on residential foreclosures. The moratoriums will remain in effect until March 6 for JPMorgan and March 12 for Citigroup.
- * February 2009: U.S. President Barack Obama signs the \$787 billion American Recovery and Reinvestment Act of 2009 into law.
- * February 2009: The Australian Government seeks to enact another "economic stimulus package".
- * February 2009: 2009 Eastern European financial crisis arises.
- * February 2009: The Bank of Antigua is taken over by the Eastern Caribbean Central Bank after Sir Allen Stanford is accused by U.S. financial authorities of involvement in an \$8bn (£5.6bn) investment fraud. Peru, Venezuela, and Ecuador, had earlier suspended operations at banks owned by the group.
- * February 23, 2009: The Dow Jones Industrial Average and the S&P 500 indexes stumbled to lows not seen since 1997.
- * February 27, 2009: The S&P index closes at a level not seen since December 1996, and also closes the two month period beginning January 1 with the worst two month opening to a year in its history with a loss in value of 18.62%

MARCH

- * March 2, 2009: The S&P index finishes the first trading day of March with a drop of 4.7%, the worst opening to a March in NYSE history.
- * March 6, 2009: The UK Government takes a controlling interest in Lloyds Banking Group by insuring their debt.
- * March 8, 2009: United States bear market of 2007–2009 declared
- * March 18, 2009: The Federal Reserve announced that it will purchase \$1.15 trillion in U.S. assets (\$750 billion in mortgage backed securities, \$300 billion in Treasuries, \$100 billion in Agencies) in a bid to prop up liquidity and lending to spur economic growth. The markets initially rallied on the news, however concerns began to grow regarding long term devaluation of the U.S. dollar and subsequent inflation.
- * March 23, 2009: In the United States, the FDIC, the Federal Reserve, and the Treasury Department jointly announce the Public-Private Investment Program to leverage \$75–\$100 billion of TARP funds with private capital to purchase \$500 billion of Legacy Assets (a.k.a. toxic assets).